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SUBJECT: THE VAZQUEZ ADMINISTRATION AT THE HALFWAY MARK

REF: MONTEVIDEO 0853

Classified By: Ambassador Frank E. Baxter  
for reasons 1.4(b) and (d)

¶1. (C) Summary: The Frente Amplio (FA) government of President Vazquez passed its halfway mark last month. This cable provides our assessment of the first half of the Vazquez administration as it relates to foreign relations, economic policy and domestic issues. Our overall assessment is positive and one that bodes well for the stability of Uruguay and for the bilateral relationship with the U.S. That said, we believe that Uruguay's traditional moderation should not be taken for granted and continued engagement is of the essence, as the FA still contains radical and old-line socialist elements.

¶2. (C) Since March 2005, Uruguay's Foreign policy has been characterized by pragmatism, some confusion and a much closer relationship with the U.S. than had been initially expected, culminating in Vazquez's visit to Washington in May 2006 and President Bush's visit to Montevideo in March 2007. The key to this engagement has been trade, but we are now expanding our dialogue to other issues such as security. Uruguay's relations with Mercosur have been tense, and Vazquez's talk of "more and better Mercosur" has not materialized. The pulp mill dispute with Argentina brought relations with this close neighbor to their lowest point in decades. The relationship with Cuba has been minimal. As for Venezuela, there have been some business deals --mostly oil with favorable financing terms and barter agreements--, lots of unfulfilled promises by Chavez, but not much else. The GOU's involvement in Telesur is also minimal, but the station broadcasts a continuous stream of anti-U.S. propaganda in Uruguay. On military matters, the GOU continues its strong participation in PKO, in particular in Haiti and the Congo. There remains a reluctance to allow exercises with "U.S. boots on the ground."

¶3. (C) Orthodox macroeconomic policies, good debt management and high commodity prices have fostered continued strong growth, with inflation under control and dropping

unemployment. Foreign trade is more diversified than ever and has reached record levels. The forestry sector is taking off as one of Uruguay's leading exports in the near future, with very significant foreign investments in the billions of dollars. Brazilian investment in agro-industry has been quite strong. On the micro side, initial moves favoring labor unions backfired, leading to several occupations of plants. The GOU appears to be backtracking. The most controversial initiative has been the tax reform spearheaded by Economy Minister Astori, which instituted for the first time a personal income tax. The middle class is being hit particularly hard and the opposition has seized on this unpopular tax as a major issue for the next election campaign.

14. (C) The FA administration started out by playing both government and opposition, as various ministers publicly voiced opposite views and claimed to speak for the government. This made for contradictory signals in both foreign and domestic policy over the first year of government. Over time, Vazquez's repeated interventions have brought about a more consistent and predictable expression of the government's policies. However, while disagreements are not expressed in public as often as they used to be, strong differences of opinion remain among Cabinet ministers. The relationship with the opposition parties remains tense, and the opposition has tended to be obstructionist as a "payback" to the FA for when it was in opposition. Human rights issues dating back to the dictatorship have taken less of a role in recent months, though the far-left continues to beat this drum. Finally, while the next election is still two and a half years away, potential candidates both within the government and in the opposition, are seriously beginning to position themselves. Vazquez has pledged he would not run for re-election (this would require a constitutional amendment), but some insiders tell us that he may do so in the end, as no other candidate appears to have the requisite appeal needed to hold the FA coalition together. End Summary.

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FOREIGN POLICY: POSITIVES  
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15. (C) Constructive relationship with the U.S.: President Vazquez is proving to be a pragmatic leader, bent on building a constructive relationship with the U.S. The positive state of current bilateral relations would have been unthinkable before the traditionally "anti-imperialistic" Frente Amplio took office. Vazquez's visit to Washington in May 2006 and President Bush's visit to Uruguay in March 2007 cemented a rapprochement at the highest levels. Several high-level visits followed, including U/S Burns, A/S Tom Shannon, Treasury Secretary Paulson and Commerce Secretary Gutierrez.

16. (C) Trade and investment agreements: President Vazquez personally signed a Bilateral Investment Treaty (BIT) with President Bush in Mar del Plata in November 2005, and obtained quick ratification by the Uruguayan Parliament. The BIT entered into force in November 2006. After coming close to initiating talks on a Free Trade Agreement (FTA) in September 2006, the GOU agreed to a Trade and Investment Framework Agreement (TIFA), which it signed in January 2007. A first meeting of the Trade and Investment Council (TIC) subsequently took place in Washington in April, where eleven working groups were tasked with discussing issues that do not require congressional notification. A stocktaking meeting of the next TIC is tentatively set for late November in Uruguay, to determine the way forward.

17. (C) Rapprochement with Chile: In April 2007, President Vazquez traveled to Chile with four ministers and a large delegation of businessmen. Presidents Bachelet and Vazquez, both of them physicians, have developed an excellent personal rapport. Finance Minister Astori also has a good rapport with his Chilean counterpart Andres Velazco, who suggested to Secretary Paulson that Uruguay be included in the Secretary's

meetings of like-minded countries. One such meeting, uniting the Finance Ministers of Chile, Mexico, Uruguay and the U.S. took place in July in Montevideo. In the ministers, private meeting, Astori highlighted the similarities between Chile's and Uruguay's economic policies.

¶18. (C) Business deals with Chavez, not much more: While he visited Venezuela and hosted Chavez on several occasions, Vazquez has carefully avoided supporting Chavez's populist policies for Latin America. Chavez himself tends to be subdued when he visits Uruguay, where he has not been provided a venue for large gatherings, as has been the case in other countries. The GOU eventually joined Chavez's Banco del Sur, but has expressed some misgivings about the organization, indicating its clear preference for multilateral financial institutions. In Vazquez's words, "Uruguay must be present, but the exact nature of its participation has yet not been defined." Agreements with Chavez have been business deals, mostly oil purchases at preferential rates and barter deals exchanging Uruguay's agro expertise and software for Venezuelan oil. Venezuela's bank Banesco also bought out a failed Uruguayan financial institution. Vazquez has not endorsed Chavez's revolution, nor accepted his leadership in the region, and Uruguay is not taking part in ALBA, Chavez's project to counter the FTAA. Still, in his capacity as Mercosur's pro-tempore president, Vazquez has publicly stated his support for Venezuela's integration into Mercosur.

¶19. (C) Minimal relations with Cuba: Vazquez's first political act upon taking office was to restore diplomatic relations with Cuba. There has not been much contact with the Cuban regime since then. While he has repeatedly been invited to visit the island, Vazquez has consistently declined the offer, blaming his busy agenda. Only the Minister of Health and the Minister of Social Development (Communist leader Marina Arismendi) have traveled to Cuba. The GOU sent over 1,800 patients for eye-surgery in Cuba, a controversial move that drew loud protests from local ophthalmologists. This program has now been terminated.

¶10. (C) Pol/mil cooperation and PKO participation: Uruguay's participation in UNITAS exercises and peace-keeping operations (PKO) were controversial at the beginning. Uruguay participated in UNITAS operations in 2005, but turned them down in 2006. Still, the country took part in Panamax 2007, and the Minister of Defense has started a discussion on participation in the 2008 UNITAS exercises. Uruguay continues to be the highest contributor to PKO on a per-capita basis, with important contingents in both Haiti and the Congo.

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FOREIGN POLICY: NEGATIVES  
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¶11. (C) Low marks for Gargano: Minister of Foreign Affairs Gargano gets the lowest marks. In spite of disagreements over foreign policy issues, Vazquez has kept Gargano in office, so as to maintain the delicate balance between the factions of his coalition. Vazquez has, however, excluded Gargano from important issues, such as the paper mill negotiation with Argentina and trade talks with the U.S. An old-fashioned Socialist, Gargano is generally hostile to the U.S. and is the main opponent to an FTA with the U.S. He demonstrated this during his speech at the UNGA. Gargano was also the driving force behind the GOU's support for Venezuela's accession to Mercosur and the subsequent ratification of this accession by the Uruguayan Parliament. He strongly supports Bansur and Parlasur as tools for closer political and economic integration.

¶12. (C) Deep disappointment with Mercosur: The relationship with Mercosur remains tense and the GOU is deeply disappointed with the bloc's failure to address Argentina's perceived aggression against Uruguay in the pulp mill dispute. The business community continues to be vocal in its criticism of Mercosur, and there is a clear cut within the

GOU. While Foreign Minister Gargano is an adamant supporter of Mercosur, Economy Minister Astori is very critical of the bloc's inaction and of Brazil's lack of leadership. Astori has repeatedly pressed Mercosur for a decision on granting Uruguay the flexibility to negotiate an FTA with the U.S. He has pledged to keep pressing during Uruguay's current pro tempore presidency and has warned that Uruguay's patience is limited. President Vazquez's position has also been quite critical of Mercosur, but he has never explicitly stated an intent to leave the bloc altogether.

¶13. (C) An ineffective Parlasur: Mercosur's Parliament has so far failed to vote on relevant issues, such as the ongoing pulp mill conflict, the integration of Venezuela into the bloc or Chavez's decision not to renew RCTV's license. In the first Parlasur meeting, the Argentine delegation unexpectedly left the floor ) allegedly to catch their flight ) when Uruguayan parliamentarians motioned to discuss the RCTV case. Venezuela's entire delegation did not show up at the second meeting, allegedly because they could not find seats on commercial flights. Everyone was present at the third meeting, however, when an Uruguayan Representative finally tabled the RCTV issue, prompting an irate reaction from the Venezuelan representatives.

¶14. (C) Strained relations with Argentina: The conflict with Argentina over the pulp mills has greatly deteriorated the

relationship between the two neighbors. The ongoing conflict has sometimes reached extremely tense peaks, something unthinkable before Vazquez took office, given the traditionally strong bonds between the two countries.

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ECONOMIC POLICY: POSITIVES  
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¶15. (C) Sound economic policy: Uruguay has continued to enjoy robust growth rates of 6.0%-7.0% per year, thanks to strong macroeconomic policies, renewed market confidence, and a booming world and regional economy that has propelled exports. Uruguay's external sector remains strong, with buoyant exports and import growth driven by large foreign direct investment projects. Real wages rose 11% since the FA took power, especially in the private sector, which was hit hardest by the 1999-2002 crisis. Unemployment has dropped to under 10% in mid-2007. In a recent speech to commemorate the halfway mark of his administration, Vazquez pledged that "there will be no change in economic policy."

¶16. (C) Sound debt and fiscal management: Abundant international liquidity has allowed the GOU to apply good debt management policies. Since March 2005, the GOU has extended the time structure of its debt and managed to slash the debt/GDP ratio from 100% in 2003 to its current 70%. Risk rating firms have upgraded Uruguay's credit rating several times, and the country risk now stands at about 200 points. Despite a significant increase in public expenditure, fiscal accounts remain strong with primary surpluses averaging about 4% of GDP since 2004.

¶17. (C) Good relations with the IFIs and a recovering financial system: In late 2006, the GOU made an early repayment of its entire debt with the IMF (\$1 billion) and canceled its stand-by program. However, contrarily to neighboring Argentina, the GOU sought to preserve a working relationship with the Fund. The IMF recently praised macroeconomic developments and assessed that "Uruguay has largely reduced its economic vulnerabilities." The financial system continues to recover from the 2002 banking crisis. Deposits and credits are on the rise, delinquency rates are falling, and banks' balance sheets show positive figures.

¶18. (C) Growing foreign investment: Uruguay is receiving large amounts of foreign direct investment (FDI). Brazilian investors have been particularly active of late and now control about 30% of Uruguay's beef exports. FDI was 4.3% of GDP in 2005 and hit 7% of GDP in 2006, way above the

historical average of 1.5% of GDP. The GOU sent positive signals of standing up for contracts and the rule of law by consistently defending Botnia's pulp mill from Argentina's attacks. The plant's operations should start within the next month.

¶19. (C) Expanding bilateral trade with the U.S.: The U.S. was Uruguay's first export market in 2004 and 2005, and is now its second largest, slightly behind Brazil but 70% larger than Argentina. U.S. exports to Uruguay have also increased significantly, exceeding in the first 7 months of 2007 their total for the entire year in 2006.

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ECONOMIC POLICY: NEGATIVES  
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¶20. (C) Distortions in labor market and a bias towards unions: The most negative facets come from the Ministry of Labor, headed by an ex-MPP leader. The FA has strengthened existing unions and provided incentives for the creation of new ones. The labor Ministry is perceived as biased against business, and various laws have strengthened workers' rights.

Several plants were occupied by workers in the early stages of the FA government, but it appears that the GOU is now backtracking, after realizing the negative impact of these situations on the rule of law and property rights. The number of labor conflicts has come down significantly, as new regulations are being implemented to control excesses.

¶21. (C) Fears of inflation and some meddling with prices: Inflation picked up in 2007, due to a combination of external and internal factors. The 12-month inflation through August 2007 was above 9%, well above the Central Bank's range of 4.5%-6.5%. Minister of Agriculture Mujica has been pressing the private sector to control prices, while Astori has resisted any attempt at price controls.

¶22. (C) Negative signal on land ownership: In 2007, the GOU passed a law limiting the ability of corporations to own land. The law does not discriminate between foreign or national investors, but is certainly a deterrent to major investors. The GOU later met with executives from Weyerhaeuser, the largest U.S. holder of forested land, to assure them that they would be exempted from the law. The real targets of the law appear to be shell companies and in some cases pension funds.

¶23. (C) A controversial tax reform: In mid-2007 the GOU instated a major tax reform that instituted for the first time a personal income tax (a central campaign proposal from the Frente Amplio.) The new personal income tax only affects incomes generated in Uruguay (income generated abroad is exempt), with progressive rates ranging from 10% to 25%. Given the extremely limited number of deductions, this personal income tax close to a tax on wages. The impact on middle class families has been severe and is bound to affect savings and consumption. The tax reform lowers corporate taxes, however, and offers incentives for investment.

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DOMESTIC ISSUES: POSITIVES  
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¶24. (C) The FA coalition remains intact: President Vazquez has done a good job at holding together his coalition, an heterogeneous grouping of seven large factions. In his non-confrontational and pragmatic style, Vazquez tends to come in with his decision at the last moment, after the factions have fought it out among themselves to exhaustion. The coalition then rallies around his decision. He has managed to garner parliamentary support for all of his initiatives.

¶25. (C) Old human rights issues have been contained: The FA came to power pledging to expose the truth about human rights abuses during the dictatorship and going after the people responsible for these actions. The issue of the



"desaparecidos" (missing persons) was at the top of the agenda, and so was the eventual repeal of the "Ley de caducidad" (the amnesty law). In the end, what could have turned into a frenzy for revenge was handled in a slow and deliberate Uruguayan way, with just enough progress on the issue of the missing persons, and a decision by the President not to repeal the amnesty law. The public in general appears to approve the decision not to reopen a painful past.

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DOMESTIC ISSUES: NEGATIVES  
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¶26. (C) A tense relationship with the opposition: Throughout the first half of his term in office, Vazquez and his government have had a rough relationship with the opposition. At first shocked by their defeat, opposition parties have started to be more aggressive on issues such as the tax reform, the deals with Venezuela, alleged malfeasance in public casinos, and in general making life as difficult for the GOU as the FA used to make it for them. The Blanco Party has been particularly aggressive, as it appears to have the best chances against the FA in the 2009 contest. Popular support is falling for the Frente Amplio and growing for the Colorados.

¶27. (C) Cracks are appearing within the FA: The MPP, the FA's major faction that got 39% of votes in the past elections, recently split when Fernandez Huidobro left the group led by radical leader Marenales to create a new faction called CAP-L. Mujica's leadership had been so far undisputed, but the excision could create more internal frictions within the MPP. This is relevant since Mujica has acted as a key articulator amongst FA's factions and has so far remained loyal to President Vazquez. As the proponent of the recent tax reform, Astori has lost ground with the middle class and has been criticized within the FA itself. There seems to be an open season on Astori within the FA.

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COMMENT: A MODERATE AND PRAGMATIC GOVERNMENT  
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¶28. (C) At its halfway mark, the FA government has proved to be surprisingly pragmatic, having made few significant changes to the foreign or economic policy of the previous governments. There have not been any of the marked shifts so common to the region, with constituent assemblies, nationalizations or populism. The reasons probably lie with Uruguay's strong middle class -the largest in proportion to the population in Latin America, with the best income distribution- and the profoundly conservative nature of its society, which prizes stability and civility and abhors radical change. The Uruguayan proclivity to civil discourse made the strident and threatening tone of the Argentine protests in the paper mill dispute all the more shocking to Uruguayans. The GOU was deeply disappointed by Mercosur's inaction and Brazil's lack of leadership in trying to resolve this dispute. As for relations with populist regimes, symbolic gestures were made to Cuba early on, and the GOU has been civil with Chavez, negotiating business deals when convenient. Bolivia's Morales and Ecuador's Correa have been more or less ignored. The most welcome development has been the positive and broad relationship developed with the U.S., a move that further isolates the most anti-American members of the ruling coalition.

¶29. (C) The very nature of the FA, a broad coalition ranging from the extreme left to the moderate center-left, seems to have prevented any radical moves. Vazquez has had to tack constantly from one side to the other, trying to maintain a course that increasingly appears aimed at emulating Chile's model of development. However, the incessant -but politically necessary- tacking has made progress painstakingly slow and has led to missed opportunities, such as that of initiating FTA talks with the U.S., a real possibility in early 2006.

¶30. (C) As we move to the second half of Vazquez's term, the next election looms larger. Vazquez has pledged he would not run for re-election (this would require a constitutional amendment), but some insiders tell us he may do so in the end, as no other candidate appears to have the appeal to hold the FA coalition together. Already pre-candidates are positioning themselves. Astori, the heir apparent, may have seriously damaged his chances with his unpopular tax reform. Not one to lose an opportunity, ex-President Batlle recently called on the opposition to agree on a thematic program (reftel) that includes a repeal of the personal income tax. There is now talk of Vice-President Nin Novoa as the possible FA candidate, with Interior Minister Tourne (a Socialist) possibly as his running mate. On the opposition side, Blanco candidates are also positioning themselves, with ex-President Lacalle and Senator Larranaga the ones with the best chances. For the Colorados, senators Abdallah and Bordaberry lead the pack. Polls indicate that there would probably be a second round in the 2009 election, and that the opposition may have a shot at winning it, but it is still very early in the game. Overall, the seamless transition to a leftist government and the responsible way in which this administration has governed clearly highlight Uruguay's strong democratic principles, solid institutions and stable society. End Comment.

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